LIFE INSURANCE IN ESTATE PLANNING

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This article will deal with some of the more common uses of life insurance in estate planning. Most estate planning problems involving life insurance should be viewed from three standpoints: (1) Will the proposed plan or transaction result in additional income taxes or a shifting of the burden of income taxes? (2) Will the proceeds of the policy be subjected to estate or inheritance taxes? (3) Will a gift of the policy or of its proceeds result in the imposition of a gift tax?

INCOME TAX

It is of course elementary that the lump sum proceeds of a life insurance policy paid on account of the death of the insured are not subject to income tax.[1] This is true no matter who the beneficiary of the proceeds may be; that is to say, whether the beneficiary is an individual, or the estate of the insured, or a corporation, lump sum insurance proceeds of a life insurance policy paid on account of the death of the insured are not subject to income tax.[2] The exclusion from taxability extends to all death benefit payments having the characteristics of life insurance proceeds payable by reason of death, even though the particular contract is not specifically designated as a life insurance contract. Thus, death benefits payable under endowment contracts, workmen's compensation insurance contracts, or accident and health insurance contracts are not included in taxable income.[3]

There are some instances, however, where the proceeds of life insurance policies, or at least a portion of these proceeds, are subject to income tax. Thus, if a life insurance contract is purchased for a valuable consideration, that portion of the proceeds which the owner or beneficiary receives which is in excess of the consideration paid for the contract and of the premiums paid after the transfer, is taxable.[4] However, there is also an exception to this rule: if the policy is transferred either (1) to the insured, or (2) to a partner of the insured, or (3) to a partnership in which the insured is a partner, or (4) to a corporation in which the insured is a shareholder or officer, then none of the insurance proceeds are taxable even though the transfer was for a valuable consideration.[5]

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1 Int. Rev. Code of 1954, § 101(a)(1).

2 Treas. Reg. § 1.101-1(a) (1957).

3 *Ibid.*

4 Int. Rev. Code of 1954, § 101(a)(2).

5 Int. Rev. Code of 1954, § 101(a)(2)(B).

Deductibility of Premium Payments

Premium payments on life insurance policies, as such, are not deductible. Generally, if the premium payments are made by an individual, they are personal or living expenses and are therefore not deductible.[6] A specific provision of the Internal Revenue Code prohibits an employer from deducting premiums on a policy on the life of an employee or of a person financially interested in the employer's business when the employer is the beneficiary under the policy.[7]

There are some instances when premium payments on life insurance policies are deductible and the owner of the policy is required to take the amount of the premiums into his income. This is the case where the employee or his beneficiary has a nonforfeitable right to the policy and the employer pays the premiums. In such instances the premium payments are of course additional salary to the employee and, if reasonable in amount, are deductible as salaries paid by the employer. Alimony agreements sometimes provide that the husband shall keep in effect an insurance policy on his life with the wife as beneficiary. The Treasury has ruled that if the policy is assigned absolutely to the wife and she is named as irrevocable beneficiary, the premiums are deductible by the husband and taxable to the wife.[8]

ESTATE TAX

If the life insurance proceeds are payable to the insured's executor (that is, to his estate), the proceeds are included in the value of the decedent's gross estate for purposes of the federal estate tax.[9] This is true even though the insured paid no premiums on the policy and possessed no incidents of ownership in the policy at the time of his death.

Insurance proceeds receive more favorable treatment under the Ohio inheritance tax law than under the federal estate tax provisions. Section 5731.06 of the Ohio Revised Code provides that life insurance proceeds are not subject to the Ohio inheritance tax unless they are paid to the insured's estate. If they are so paid, then the inheritance tax applies, and in this respect, the federal estate tax law and the Ohio inheritance tax law are the same. However, the similarity ends here. Under the federal estate tax law the proceeds of life insurance policies are part of the taxable estate if the decedent possessed any "incidents of ownership" in the policy at the time of his death or if he had a reversionary interest in the policy amounting to more than

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6 Int. Rev. Code of 1954, § 262.

7 Int. Rev. Code of 1954, § 264(a)(1).

8 I.T. 4001, 1950-1 Cum. Bull. 27.

9 Int. Rev. Code of 1954, § 2042(1).

five per cent of the policy's value at the time of death.[10] There are no comparable provisions in the Ohio inheritance tax law. Thus, if an insured died possessing all of the incidents of ownership in a $100,000 policy on his life in which his wife was named as beneficiary, the proceeds of the policy would be included in his taxable estate for purposes of the federal estate tax; the proceeds would not, however, be subject to the Ohio inheritance tax.

The usual "incidents of ownership" in an insurance policy include the right to borrow on security of the policy, to surrender the policy and receive its cash value, to assign the policy, to receive dividends on the policy, to change the policy beneficiary, to convert the policy to paid-up or extended insurance, and to exercise options in the policy.[11] A "reversionary interest" in a policy means a possibility that the policy or its proceeds may return to the decedent or his estate.[12] This possibility may be valued actuarially.[13] If the chances are better than one out of twenty that the decedent or his estate will come into possession of the policy or its proceeds, the decedent will be considered to have a reversionary interest in the policy with a value of more than five per cent; and in this event, the entire proceeds of the policy will be included in the decedent's taxable estate even if none of the proceeds were ever actually received by the estate. The Estate Tax Regulations provide references to tables and material for the valuation of remainders and reversions.[14]

Before the adoption of the 1954 Internal Revenue Code, insurance proceeds became a part of the gross estate if (a) the proceeds of the policy were payable to the insured's executor or estate, or (b) the insured possessed any incidents of ownership in the policy at the time of his death, or (c) paid the premiums on the policies.[15] The 1954 Code eliminated the premium payment test for taxability.[16]

Gift Tax

With the abolition of the premium payment test, gifts of insurance policies, with the donor continuing to pay the premiums on the policy after the transfer, became quite common as a device to avoid estate taxes. However, as we shall see later, there is still a possibility that the proceeds, or a portion of the proceeds, may become part of the insured's taxable estate if he continues to pay the premiums after

[10] Int. Rev. Code of 1954, § 2042(2).
[11] Treas. Reg. § 20.2042-1(c)(2) (1958).
[12] Treas. Reg. § 20.2042-1(c)(3) (1958).
[13] Treas. Reg. § 20.2037-1(c)(3)(4) (1958).
[14] Treas. Reg. § 20.2031-7 (1958).
[15] Int. Rev. Code of 1939, § 811(g).
[16] Int. Rev. Code of 1954, § 2042.

making an irrevocable transfer of the policy, because of the transfer "in contemplation of death" rule.

Gifts of life insurance policies are subject to the gift tax; and if the insured continues to pay the premiums after the transfer, the premium payments may be also taxable as gifts.[17]

If the policy is a paid-up policy, the value of the gift is the cost of a comparable policy to the insured at the date of the gift. If the policy is the so-called ordinary life policy calling for continuing premium payments, then, for all practical purposes, the value of the gift is the cash surrender value of the policy.[18]

Under the federal gift tax stautes, every person has a lifetime exemption of $30,000 and married couples have a lifetime exemption of $60,000, or in other words can give away $30,000, or if married $60,000, tax-free;[19] in addition, there is an annual "exclusion" of $3,000 (or $6,000 for married persons) for each gift of a present interest.[20] A gift of a "future interest" does not qualify for the annual exclusion. Any gift which the donee does not have a present right to enjoy or possess in full is the gift of a "future interest." The term "future interest" does not have the same meaning in gift taxation as it does in the law of real property and conveyancing, and therefore it is not necessary to resort to all the property law subtleties to determine whether a particular gift is one of a future interest. For purposes of the gift tax, the donee must be able to possess or enjoy the gift immediately if the donor is to be able to take advantage of the annual exclusion.

The outright gift of an insurance policy which transfers all the incidents of ownership to the donee will qualify for the annual exclusion.[21] Where the value of the policy exceeds the amount of the exclusion, it may still be possible to take full advantage of the exclusion provision by splitting the policy into two or more policies. For example, if a grandfather entitled to an annual exclusion of $6,000 wishes to give an insurance policy having a value of $12,000 to his two grandsons, he may make arrangements with the insurance company to split the policy into two policies, each having a value of $6,000, and then make a gift of the separate policies to the grandchildren. Or, if the insurance company should refuse to split the policies, the same result could be achieved by the owner borrowing a sufficient amount

17 Treas. Reg. § 25.2511-1(h)(8) (1958).

18 Treas. Reg. § 25.2512-6 (1958).

19 Int. Rev. Code of 1954, §§ 2513, 2521 and 2523.

20 Int. Rev. Code of 1954, § 2503(b).

21 Rev. Rul. 55-408, 1955-1 Cum. Bull. 113; Treas. Reg. §§ 25.2503-3(a), 25.2503-3(c), example (6) (1958).

on the policy to bring its value down to the amount of the annual exclusion and then making a gift of the policy. In later years, the donor could repay the loan by making cash gifts to the donee, or making direct payments to the insurance company, which would qualify for the annual exclusion. The possible disadvantage of this latter plan is that the donor by borrowing on the policy may incur an obligation for interest on money for which he has no present need.

In order to keep the gift tax to a minimum, it is sometimes suggested that older policies with a high cash surrender value be retained and that newer policies with a lesser value be transferred; or that the insured should take out a new policy with little or no cash surrender value and then transfer the newly issued policy to the donee. This latter plan is practicable, however, only if the insured is still insurable and the premium cost is not prohibitive.

There are some obvious disadvantages to outright gifts of insurance policies, aside from the possible gift tax burden. If a husband makes a gift of a policy on his life to his wife and a marital rift later develops, the wife will be able to keep the policy as her own entirely apart from the provisions of any divorce decree or property settlement. A gift of an insurance policy with a substantial cash surrender value to a minor or an improvident child who has the unfettered right to withdraw the cash surrender value or borrow on its security may be subsequently regretted. Or ownership of the policy might pass from the donee to a son-in-law or daughter-in-law by decree of a divorce court.

There are also complications if a policy given to a wife or a child later returns to the donor by will or by intestacy upon the donee's death. The cash surrender value of the policy is included in the donee's taxable estate. A second gift of the policy by the donor in order to keep the proceeds out of his estate may result in a second gift tax on the policy. Moreover, the reacquisition by a husband of a policy upon his life at the death of the wife is particularly inopportune, since it increases the husband's potential taxable estate at the very time his estate loses the benefit of the marital deduction.

An outright gift of the policy removes the proceeds from the donor's estate, but those proceeds, if kept intact or invested in other property which is on hand at the donee's death, will be included in the donee's estate. Thus, in such a case, a gift of the policy does not necessarily eliminate the estate tax on the insurance proceeds; it merely shifts the tax from the donor's estate to the donee's estate.

Many of the objections to outright gifts can be eliminated by the use of insurance trusts. If a trustee rather than a donee is vested with all the legal incidents of ownership during the lifetime of the insured, it is possible to keep a policy from passing into unfriendly hands or prevent its value from being dissipated by a spendthrift child. Moreover, by the use of a trust an estate tax upon the death of the life beneficiary of the trust may be avoided. The imposition of an estate tax may be deferred to the death of the grandchildren and by that time the proceeds may be spent or divided into so many small portions that the estate tax would not be significant. But there are also some disadvantages to an insurance trust which we will now examine more closely.

Insurance Trusts

The insurance trusts with which we are here concerned are inter vivos trusts. Insurance trusts may be either revocable or irrevocable and also may be either funded or unfunded. By a funded trust is meant a trust which contains in addition to life insurance policies, securities or other property which will yield sufficient income for the payment of premiums on the life insurance policies. The corpus of an unfunded trust will consist of life insurance policies and possibly other property of a relatively insignificant amount. The premiums on the policies in an unfunded trust are paid not from income of the trust, but by the insured or the owner or beneficiary of the policies.

Revocable Unfunded Trusts

A very popular device today is the revocable unfunded insurance trust. Under this form of trust, the insured creates a trust during his lifetime which will receive at his death the proceeds of insurance upon his life. The trustee is designated as the beneficiary and is given physical possession of the policy.

To remove any challenge to the legal sufficiency of the trust on the ground that the insurance policy is a mere "expectancy" and that therefore the trust has no "corpus," other property, such as a savings bond or cash, may also be transferred to the trustee. The insured retains most of the incidents of ownership in the policy, including the right to surrender, to borrow on the security of the policy, to change the beneficiary or to revoke the trust and regain possession of the policy. The trust instrument will provide that the trustee is authorized to receive assets in addition to the insurance proceeds, and particularly property that will be transferred or "poured-over" from the insured's probate estate. The trustee is also usually authorized to make advances to or purchase property from the insured's executor in order to provide the estate with liquid funds to pay debts and taxes. The terms of the trust instrument may provide in great detail for the disposition of the insured's estate, including the usual marital deduction and nonmarital deduction trust provisions. The trust instrument thus substitutes in large part for a will. Where the terms of the trust are detailed and explicit, the will is usually very brief, designating an executor with the standard powers, making specific disposition of the testator's household goods, personal effects and residence property, and bequeathing the residue to the trustee of the insurance trust.

The revocable insurance trust may also be made the receptacle for non-probate assets other than insurance, such as death benefits payable under qualified pension or profit sharing plans. These benefits are, to the extent of the employer's contribution under the plan, free of the federal estate tax as a general rule, but this important exemption is lost if the employee designates his estate as beneficiary.[22] By designating the trustee as beneficiary the exemption may be preserved.

There are practical advantages to a revocable insurance trust. The trust will not be subject to the continuing supervisory jurisdiction of the probate court; and if it is an important consideration the major testamentary disposition of the testator will not be a matter of public record. To the extent that the decedent's assets do not pass through the probate estate, there will be a saving in administration expenses. The standard settlement options available in insurance policies may not be flexible enough to meet the needs or plans of the insured; under a trust arrangement the methods of distribution of principal or income to the beneficiary are practically unlimited, restricted only by the ingenuity of the insured or his advisor. The power of the trustee to sprinkle income among the beneficiaries of the trust—distributing income to those who need it and withholding income from those who have no need for it and are already in a high tax bracket—will usually result in income tax advantages to the beneficiaries. The proceeds of the insurance policies may be invested by the trustee to yield a higher rate of return than would ordinarily be available under standard settlement options, and thus the trust fund may serve as a valuable hedge against inflation.

Legally speaking, the validity of the pour-over revocable trust seems to be rather generally recognized, although its status is not as clear in some jurisdictions as in others. An Ohio court of appeals has ruled that insurance proceeds payable to a *testamentary* trustee lose their exempt status under the Ohio inheritance tax laws, at the same time expressly stating that the exemption statute contemplated the creation of a trust *inter vivos*.[23] Another Ohio court of appeals has ignored an amendment to an inter vivos trust where the amendment was made after the execution of a will designating the trustee

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22 Int. Rev. Code of 1954, § 2039(c); Treas. Reg. § 20.2039-2(b) (1958).

23 *In re* Rothenbuecher, 76 Ohio App. 425, 64 N.E.2d 680 (1945).

as beneficiary.[24] This suggests the advisability of a codicil to the will, republishing it after amendments to the trust, in order to validate the pour-over from the probate estate upon the amended terms.

In cases where the grantor of the trust is the insured as well as the owner of the policy, the tax effects of the revocable insurance trust, with the one exception mentioned later, appear to be negative; that is to say, there are no tax advantages or disadvantages compared with outright ownership of the policy during lifetime and payment under one of the settlement options at death. The grantor of the trust must pay premiums out of income which has already been subjected to tax and there is thus no saving in income tax. Because the trust is revocable and the grantor has retained incidents of ownership in the policy transferred to the trust, the death proceeds are includible in the grantor's gross estate for federal estate tax purposes. No gift tax will be incurred because there has been no absolute divestment of ownership of the policy. The tax disadvantage connected with the revocable insurance trust is this: if the proceeds of policies are left with an insurance company for payment under one of the installment options, up to $1,000 of the interest element included in such payments may be excluded from taxable income when the payments are made to a widow or widower.[25] This $1,000 exclusion is lost if the proceeds are paid over by the insurance company to the trustee who, in turn, distributes them to the widow or widower.

In most revocable insurance trusts the grantor of the trust is the insured as well as the owner of the policy. It is possible, of course, that the owner of the policy and the grantor of the trust may be someone other than the insured. Where the insured and the owner and the beneficiary are three different persons, there is a gift tax pitfall which exists whether or not a trust is employed. If, for example, the wife takes out an insurance policy on the life of the husband, the wife retaining all incidents of ownership in the policy, with their children being named as beneficiaries of the policy, the wife is considered to have made a taxable gift to the children of the full amount of the insurance proceeds at the time of the death of the husband.[26] The theory is that the right of the policy owner, the wife, to revoke the beneficiary is cut off by the death of the insured and that at this junc-

24 Koeninger v. Toledo Trust Co., 49 Ohio App. 490, 197 N.E. 419 (1934). However, a recent decision by the Supreme Judicial Court of Massachusetts has held that property passed under the terms of a trust which was amended after date of execution of the will. Second Bank—State Street Trust Co. v. Pinion, 170 N.E.2d 350 (Mass. 1960).

25 Int. Rev. Code of 1954, § 101(d).

26 Goodman v. Comm'r, 156 F.2d 218 (2d Cir. 1946), affirming, 4 T.C. 191 (1944).

ture the wife makes an irrevocable gift of the policy proceeds to the children. The case in which this proposition was formulated involved a revocable life insurance trust but the rationale would be applicable even if no trust was involved. The irony of the holding is that the wife becomes liable for a substantial gift tax upon proceeds that never come into her possession.

It may be possible to avoid the gift tax in the above situation by providing that upon the death of the husband and the payment of the insurance proceeds, the trust becomes irrevocable but is subject to a power in the wife by will to change the interests of the children as beneficiaries. This should prevent any gift tax when the proceeds are paid to the trustee, since the interest of any one beneficiary can not be fixed with certainty at that time. The same trust instrument might provide for the payment of income to the wife for her life, with the right to invade principal for her medical care and support, and after her death for the payment of income to the children for stated periods, after which the children or grandchildren could take the principal.

If the wife should create a revocable insurance trust with a policy upon her husband's life, and then should die before the husband, there is the difficulty we have mentioned before in discussing outright gifts of policies—the policy may return to the husband and increase his potential estate at the very time he loses the benefit of the marital deduction. This problem may be solved if the wife has income producing assets sufficient to pay the premiums on the policies after her death. These assets might be transferred to the trust during the lifetime of the wife—in which event the trust would be funded—or might be left to the trust by the wife's will. The trustee would have all incidents of ownership in the policy after the wife's death, and the proceeds would therefore not be includible in the husband's estate. If the wife has no separate assets of her own, it has been suggested that she might carry insurance on her life in an amount sufficient to provide funds for the payment of premiums on the policy on the husband's life after her death.

If upon the death of the wife, there are no assets available in the wife's estate to pay the premiums, the husband may of course keep the policy in effect by paying the premiums to the trustee, but in this event the payments would constitute gifts of future interests which would not qualify for the annual exclusion.[27] The loss of the annual exclusion may be important enough to warrant a decision against the establishment of a trust, if the wife has no income producing assets or is unable to take out insurance on her life to provide funds for her estate to carry the insurance on her husband's life. In the event no

[27] Rev. Rul. 55-408, 1955-1 Cum. Bull. 113.

trust is established, the wife may bequeath all incidents of ownership in the policies to the children. If the husband survives, he can then keep the policy in effect by paying the premiums. These premium payments will qualify for the annual exclusion because the children, or their guardian, will have full and present rights of ownership in the policies.

The Unfunded Irrevocable Trust

In the unfunded irrevocable insurance trust, the corpus of the trust will consist of life insurance policies which the insured or the owner has transferred or assigned irrevocably to the trustee. The trust instrument will provide that the trustee is vested with all right, title and interest in the policies and the trustee will be authorized to exercise all options and privileges under the policy. The trustee will be under no obligation to pay premiums on the policy because there will be no funds in the hands of the trustee that can be used for such purposes. Upon the death of the insured, the trustee will receive the proceeds of the policy and hold them under the terms of the trust. Usually the trust instrument will provide that the trustee is authorized to purchase assets from the estate of the insured at a fair value, thus providing a source of liquid funds to meet debts and obligations of the insured's estate.

The creation of an irrevocable unfunded insurance trust does not create any income tax problems nor provide any income tax advantages, because the premiums on the policies will continue to be paid by the insured or the owner or beneficiary of the policy out of his own previously taxed income. In other words, insofar as the payment of premiums is concerned, the grantor of the trust is in exactly the same position as if no trust had been created.

With respect to the federal estate tax, while the death proceeds will not be included in the decedent's gross estate if he has completely and absolutely divested himself of all incidents of ownership in the policies during his life, and while there is now no payment of premium test, there is still a danger that at least a part of the death proceeds may be taxable if the insured continues to pay the premiums after the transfer of the policy. This danger arises because the payment of premiums by the insured within three years of his death may be considered to be a transfer "in contemplation of death." Section 2035 of the Internal Revenue Code of 1954 provides that the value of the gross estate shall include all property which the decedent transferred during his life by trust or otherwise, in contemplation of his death. Any transfer within a period of three years of the date of death is deemed to have been made in contemplation of death unless the beneficiaries or the estate can show the contrary. On the other hand, any transfer that is made more than three years before death is conclusively presumed not to have been made in contemplation of death.

Suppose an insured took out a policy of insurance on his life and immediately thereafter transferred the policy irrevocably to a trustee but continued to pay the premiums until his death which occurred within two years of the date of the transfer of the policy to the trust. There are several ways of viewing these payments. One view would be that the only gift in contemplation of death was the gift of the two annual premiums paid by the insured before he died. Another view would be that the only gift in contemplation of death was the cash surrender value of the policies at the time of the transfer. A third possible view would be that since the entire amount of the proceeds of the policy receivable by the beneficiary were attributable to the premiums paid within three years of death, the full amount of the death proceeds should be included in the insured's estate by reason of the payment of the premiums. It seems not at all unlikely that this third view is the one which would be accepted by the courts in the example just given. The United States Court of Appeals for the First Circuit has held that where the insured paid a portion of the premiums on the policy, then made a gift of the policy and thereafter the beneficiary paid the premiums, there should be included in the insured's estate that portion of the insurance proceeds attributable to the premiums paid in contemplation of death.[28] Where the beneficiary pays no premiums after the transfer and the insured dies within three years, it would follow that the entire amount of the proceeds would be includible in the insured's estate.

Looking now at the gift tax aspect, under the terms of the usual insurance trust the beneficiaries will have no rights in the policy until it matures, when the death proceeds become available to them. During the lifetime of the insured, rights of ownership, such as the right to the cash surrender value, etc., will be vested in the trustee. Since the beneficiary does not have a present right to the trust property, the gift is one of a future interest.[29] The denial of the gift tax exclusion is probably the major tax disadvantage of the irrevocable insurance trust.

Before determining whether to make a gift of a policy or whether to establish a trust, the gift tax status of the donor should therefore be thoroughly explored. If the donor has used up his lifetime exemption of $30,000 (or $60,000 if married), or if there are other large gifts contemplated in the future, then perhaps the loss of the exclusion may be considered of sufficient importance to decide against the establishment of a trust. On the other hand, if the lifetime exemptions are

28 Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945).

29 See *supra* note 27.

still available, a trust may be desirable. It is well to remember in this connection that quite substantial gifts may be made at a very low gift tax price. Even without the benefit of the annual exclusion, a married couple can contribute $60,000 without incurring any gift tax, and the gift tax on the next $40,000 would be only approximately $2400. The sum of $100,000 could of course buy a substantial amount of insurance.

It has been suggested by some that after the gift of the policies to the trust, the beneficiary should pay the premiums on the policies. If the beneficiary has the funds to make such payments, this is of course an ideal arrangement. There are two decisions of the Tax Court holding that there is no taxable gift where a person makes payments of premiums on policies held in trust for his benefit.[30] The principle is that one does not make a gift when the contribution works for his own financial benefit—or in other words one can't make a gift to himself. The United States Court of Appeals for the Second Circuit has said that this rule is valid only where the beneficiary making the payments is the sole beneficiary of the policy.[31] If there is more than one beneficiary, a payment of premiums by one may be partially for the benefit of the other; and to this extent there would be a gift to the other.

In the usual case the beneficiary will probably not have sufficient funds to pay the premiums after the transfer of the policy to the trust. The suggestion has been made that in this event the donor may make a cash gift to the beneficiary which will qualify for the annual exclusion, and that the beneficiary may then use the cash to pay the premiums. The thought is that if the cash gift is made without any strings attached so that the beneficiary is free to spend the money for any purpose he may wish, it is the beneficiary and not the donor who is paying the premiums. If the cash were given with the express understanding that it was to be used in payment of the premiums, there would be little doubt that the Commissioner of Internal Revenue and the courts would view the gift and subsequent payment as one transaction, namely the payment of premiums by the donor. Even if the gift of cash is made without any express understanding, the Commissioner may challenge the transaction, particularly if the timing and amount of the gift coincide with the due date and amount of the premium.[32] A question of fact would then be presented to a court or a jury as to whether the cash gift was made with the implied understanding that it would be applied toward the payment of the premiums.

30 Pleet v. Comm'r, 17 T.C. 77 (1951); Seligmann v. Comm'r, 9 T.C. 191 (1947).

31 Berger v. Comm'r, 201 F.2d 171, 43 Am. Fed. Tax R. 144, 53-1 U.S.T.C. ¶ 10,885 (2d Cir. 1953).

32 *Cf.* Whiteley v. Comm'r, 120 F.2d 782 (3d Cir.), *cert. denied,* 314 U.S. 657 (1941).

Summarizing our discussion of the irrevocable unfunded insurance trust, it would seem that the practical advantages are heavily in favor of the trust over the outright gift of a policy. With a trust we may guard against the cash value of the policy being squandered by an improvident donee and prevent the ownership of the policy from falling into unfriendly hands during the lifetime of the donor or transferor of the policy. Upon the death of the insured, there will be much greater flexibility in the administration of the trust than if the proceeds had been taken in a lump sum or under one of the standard settlement options, and the investment powers of the trustee will be a hedge against inflation. The use of a trust eliminates the possibility that the insurance policy may come back to the donor if the donee should die before the donor, with the consequent disadvantage that the value of the policy will be included in the donee's estate and a second gift tax may be incurred if the donor should again transfer the policy. Moreover, with a trust an estate tax upon the death proceeds may be avoided upon the death of the life beneficiary of the trust. There are, in addition, substantial income tax advantages that may accrue to the beneficiaries if the trustee is given power to sprinkle income among them as needed.

From the standpoint of the income tax status of the donor, there are no differences between an outright gift of the policy and the transfer to an irrevocable unfunded trust. In both instances, if the insured or owner of the policy continues to pay the premiums, the premiums will come out of income that has already been taxed.

No estate tax advantage lies with the trust because the proceeds of the policy may be removed from the insured's estate by both an outright gift to a donee and an irrevocable transfer of the policy to a trustee. In each case, if the insured continues to pay the premiums on the policy after the transfer, there is the danger that at least a portion of the proceeds of the policy—that is, that portion of the proceeds attributable to the premiums paid within three years of death—will be included in the decedent's taxable estate.

From a gift tax standpoint, the outright gift of a policy to a donee has an advantage over a transfer to a trust. In the former case the donor is entitled to the benefit of the annual exclusion, whereas a transfer of a policy to an insurance trust or the payment of premiums on such a policy is considered to be a gift of a future interest which does not qualify for the annual exclusion. On the other hand, if the donor still has available his lifetime exemption, the gift of a policy and the subsequent payment of the premiums may not result in any taxable gifts, depending of course upon the value of the policy and the amount of the premiums. In any event, it may be possible to avoid any unfavorable gift tax consequences, at least after the initial transfer of the policy to the trust, if the donor contributes cash to the beneficiary of the policy with no strings attached thereby permitting the donee to pay the premiums on the policies himself. However, this device may invite a challenge by the Commissioner of Internal Revenue.

Funded Irrevocable Trusts

In the funded irrevocable trust, an insurance policy or policies, together with securities or other property yielding sufficient income to pay the premiums on the policies, are transferred irrevocably to a trustee.

If the grantor of the income producing property is also the insured under the policies held by the trust, the income from the property, to the extent it may be used to pay premiums on the policies, whether or not it is actually so used, will be taxed to the grantor.[33] Of course, in such a case the grantor would be no worse off than if he had made an outright gift of the policies or had transferred them irrevocably to an unfunded insurance trust and had continued to pay the premiums, since in each case the premiums will be paid from after-tax income.

The transfer of the policies and of the income producing securities will result in gift tax consequence without the benefit of an annual exclusion. It is interesting to note that in computing the taxable value of the gifts no deduction is allowed for the present value of the income that will be taxed to the grantor-insured over the remaining years of his life.[34]

From the estate tax standpoint, where the same person is both the grantor of the income-producing securities and the insured under the policy, there are two considerations to be taken account of: (1) Will the transfer to the trust remove the income-yielding securities from the taxable estate of the grantor? and (2) Will the death proceeds of the policy be included in the grantor-insured's estate? There is no clear-cut answer to either of these questions. We have already noted that income of a trust which may be used to pay premiums on a policy on the life of the grantor is taxable to the grantor. There are some authorities who feel that since the grantor is treated as the owner of the trust income for purposes of income taxation, this is the equivalent of a retained life interest in the policy and therefore sufficient to bring both the securities and the death proceeds into the grantor's taxable estate under section 2036 of the Internal Revenue

33 Int. Rev. Code of 1954, § 677(a)(3).

34 Beck v. Comm'r, 129 F.2d 243, 29 Am. Fed. Tax R. 809, 42-2 U.S.T.C. ¶ 10,195 (2d Cir. 1942).

Code. Apparently there is no case directly in point. The question was adverted to but not decided in *Beck v. Comm'r.*[35] Other authorities argue, with considerable persuasion it would seem, that the premium payment test was done away with by the 1954 Code and that therefore it is now irrelevant, at least for purposes of determining whether the death proceeds are subject to the estate tax, that income which may be used for premium payments is taxable to the grantor.

It may be contended with some reason that the insured retains no right to the income of a funded irrevocable trust even though it is taxed to him. The argument would be that, realistically speaking, the income originated with the trust rather than with the insured; that the grantor had parted with all incidents of ownership in the property which generated the income for the premium payments; that the transfer of the income yielding securities was subject to a gift tax; and that regardless of the income tax treatment of the premiums, the insured had no control over the property that produced the income or the income itself. If this view is correct, a funded irrevocable insurance trust may well serve to eliminate or minimize the risk of the death proceeds being included in the grantor's estate as attributable to premiums paid in contemplation of death, since the premiums would not have been paid by the insured but by the trust.

Whatever may be the merits of a funded irrevocable trust where the same person is both the grantor and the insured, a more common use of this type of trust is in cases where the grantor is not the insured. An example of this latter use is the grandfather-grandson trust where the grandfather takes out insurance on the life of his son, and transfers the policy and property yielding sufficient income to pay the premiums on the policy to a trust of which the grandchildren are beneficiaries. By this arrangement the grandfather has removed from his taxable estate the value of the securities transferred to the trust as well as the cash surrender value of the policy. This savings in estate tax is again achieved at the expense of a gift tax. Thereafter, the income yield of the securities will be taxed to the trust rather than to the grandfather. Since the trust is usually in a lower bracket, it may be expected that there will be a substantial savings in income tax. Upon the death of the son, the insurance proceeds will not be included in his estate since he possessed no incidents of ownership in the policy. If the grandfather should happen to die within three years of the establishment of the trust, none of the insurance proceeds will be included in his estate, since the grandfather is not the decedent-insured. Of course, the value of the securities, as distinguished from the insurance pro-

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[35] *Compare* Treas. Reg. § 20.2036-1(b)(2) (1958) *with* the opinion in Beck v. Comm'r, *supra* note 34.

ceeds generated by the income from the securities, might be included in the grandfather's estate as a gift made in contemplation of death if he doesn't live for three years after the transfer.

Another rather common use of the irrevocable funded trust is for a husband to make an irrevocable transfer of life insurance policies on his life to a trust, while his wife, at the same time, contributes securities yielding sufficient income to pay the premiums on the policies, with their children being named as beneficiaries of the trust. In this case the grantor of the income-producing property, the wife, and the insured, the husband, are not the same; therefore, the income from the securities will be taxed to the trust and not to the grantor of the securities. An income tax savings is thus accomplished by the shift of income from the high-bracket wife to the low-bracket trust and the insurance will consequently be purchased at a much lower over-all cost than if no trust had been created. The insurance proceeds will not be included in the estate of either the wife or the husband. Also, the wife will remove from her taxable estate the securities transferred to the trust, again at the expense of a gift tax.

The Short-Term Irrevocable Trust

Under section 673 of the Internal Revenue Code of 1954, the income from property that has been placed in trust is taxable to the trust (and not to the grantor) if the trust continues in existence for a period of at least ten years and the income is not expended or accumulated for the benefit of the grantor.

Such a short-term trust may be availed of to purchase life insurance on the life of some one other than the grantor with income that has been taxed to the low-bracket trust instead of the high-bracket grantor. The income tax savings should be weighed against the gift tax cost on the transfer of the securities or other property to the trust. The value of the gift, for purposes of the gift tax, will not be the full value of the property transferred but only the value of its use for the term of the trust.

A short-term irrevocable trust is sometimes used by a father to purchase an endowment policy for the benefit of his minor child in order to provide funds for the child's college education. When the child reaches twenty-one or any other specified age not earlier than ten years from the establishment of the trust, he receives the policy or its proceeds, payable in a lump sum or in installments. Upon the termination of the trust, or upon the prior death of the child, the corpus of the trust (exclusive of the policy or any accumulated income) will revert to the grantor. If the child dies before the termination of the trust, the proceeds of the policy and any accumulated income of the trust should go to persons other than the settlor.

A short-term irrevocable trust might also be used by a father to purchase a life insurance policy at favorable rates on the life of his young married son who is struggling to support his family and can not carry the necessary amount of life insurance himself at this particular period of his life, but should be in a position to take over the payment of premiums on the policy ten or eleven years hence.

If the grantor should die before the termination of a short-term trust, the value of his reversionary interest in the trust corpus will be includible in his gross estate.

Group Insurance

One of the most attractive tax bonanzas today is group life insurance. It has been estimated that there is over one hundred billion dollars of group life insurance in effect, and considering the tax advantages, this is not at all surprising.

The type of insurance which offers these advantages is group term insurance taken out by an employer on a group of his employees. The group life insurance program commonly covers a group of employees of the same employer, is based on renewable term insurance usually on a one year basis, and does not require medical examinations.

The group covered by the program need not include all, or any particular percentage of, the entire work force. The individuals to be covered may be chosen on the basis of any reasonable standard which does not amount to a hand picking of the particular individuals covered. Two limitations, however, apply to selection of the group: (1) the standard can not be based on age, race, or sex; thus, a group can not be limited to male employees over forty-five; and (2) a minimum number of employees must be covered.

Under Ohio law, there must be at least ten employees covered in a group insurance program.[36] There is also a limit on the amount of such insurance available to any one employee—$20,000 or $40,000, depending upon the annual compensation of the employee.[37]

The tax allurements in such insurance are that the premiums paid by the employer to carry the insurance are not taxable as income to the employee and yet are deductible by the employer. The basis for the favored treatment is not statutory but an administrative ruling and a regulation.[38] Section 1.61-2(d)(2) of the Income Tax Regulations reads in part as follows:

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36 Ohio Rev. Code § 3917.01(A) (1953).

37 Ohio Rev. Code § 3917.01(C) (1953).

38 The basis for the deduction is Law Opinion 1014, 2 Cum. Bull. 88 (1920). The basis for the exclusion from income is the regulation referred to in the text.

> . . . Generally, life insurance premiums paid by an employer on the lives of his employees, where the proceeds of such insurance are payable to the beneficiaries of such employees, are part of the gross income of the employees. However, premiums paid by an employer on policies of group term life insurance covering the lives of his employees are not gross income to the employees, even if they designate the beneficiaries. . . .

Considering the amount of the before-tax dollars that would have to be earned in order to pay the premiums on a $20,000 or $40,000 life insurance policy, the advantages of group term insurance are readily discernible.

At the present time there is quite a bit of speculation on the question whether an insured can remove group term proceeds from his taxable estate by assigning all incidents of ownership in the policy during his lifetime. The incidents of ownership in group life insurance are the same as those in other policies, including the power to change the beneficiary, the power to elect a settlement option, etc. and, in addition, the privilege of converting the group policy to an individual type of policy upon termination of employment. Doubts have been expressed whether an employee can dispose of the conversion privilege in those states where this is a statutory requirement. By providing that the employee shall have the privilege of converting, the legislature may have intended to confer a personal privilege upon the employee, exercisable by him alone at the time employment terminates; if so, any attempt to take away this privilege by assignment before termination of employment would be ineffective. It may also be argued that the insured retains an incident of ownership by reason of his right to quit his job and thus terminate the insurance. The Treasury Department may also contend that because the insurance involved is one year renewable term insurance, a gift of the insurance is made by the employee to his transferee each year the insurance is renewed, and that upon the death of the employee, the full amount of the proceeds should be included in his estate since there was a transfer in contemplation of death in each of the three years preceding death.

If the employee assigns his group term policy, the Commissioner may also attempt to tax the premium payments as income to the employee on the ground that the exclusion from income granted by the regulations is based primarily upon the employer-employee relationship, and that where the ownership of a policy is vested in a non-employee the reason for the exclusion no longer applies.

Paid-up insurance and ordinary life insurance is also available on a group basis. The tax incidents of the ownership and purchase of such insurance are, however, the same as if the employee were the owner of an ordinary individual life insurance policy upon which his employer paid the premiums. The only advantage of such insurance is that since it is purchased on a group basis, the premiums are cheaper than for individual insurance of the same type.

SPLIT-DOLLAR INSURANCE

Another widely discussed insurance plan today is split-dollar insurance. Split-dollar insurance splits or divides the cost of life insurance between an employer and his employee. The employer pays that part of the annual premium equal to the increase in cash value of the policy, while the employee pays the balance of the premium. At the maturity of the policy upon the death of the employee, the employer recoups his cost from the insurance proceeds, and the balance of the proceeds is paid to the beneficiary designated by the employee. Since the cash surrender value increases over the life of the policy, the amount of the proceeds ultimately payable to the employer increases and the amount ultimately payable to the employee decreases the longer the policy is in effect.

The primary advantage of the split-dollar plan is that it provides insurance protection to the employee at the time when he needs it most—when he is young and his family is growing and the funds available for insurance are limited.

In 1955, the Internal Revenue Service issued a revenue ruling giving its blessing to split-dollar plans. Revenue Ruling 55-173 stated that the payment of premiums by the employer on split-dollar policies would not be considered to be taxable income to the employee.[39] The premiums paid by the employer are considered by the Internal Revenue Service to be an interest-free loan to the employee. The loan is, of course, repaid at the death of the employee when the employer receives the cash surrender value of the policy.

The death proceeds of the policy received by the employer and the employee's beneficiary are not included in the taxable income of either. The employer's share of the premium is not deductible as a business expense because this portion of the premium has been merely loaned to the employee.

There are some cautions which should be observed in the use of the split-dollar plan. The revenue ruling speaks only of split-dollar insurance on the life of an employee. Whether the Internal Revenue Service would be as generous in ruling upon a split-dollar plan for a stockholder-officer is a debatable question. So-called loans to shareholders are sometimes viewed by the Internal Revenue Service as taxable dividends rather than loans. Moreover, if the advance of the

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39 Rev. Rul. 55-173, 1955-2 Cum. Bull. 23.

premiums by the employer is in reality a loan, then the corporation may be in trouble under section 531 of the Internal Revenue Code which imposes a surtax upon a corporation that unreasonably accumulates its earnings. Loans to stockholders may be evidence of an unreasonable accumulation of earnings, since if a corporation has money to lend to its stockholders, it is reasonable to assume it does not need all of its funds for use in the business. Therefore, a split-dollar insurance plan on the life of a stockholder may be an open invitation to a revenue agent to claim that the corporation is unreasonably accumulating its earnings and that the surtax should be imposed.

The employer is usually designated as the owner of a split-dollar policy. It is advisable that rights of the employer and the employee in the proceeds of the policy be spelled out in a written agreement between the parties. The agreement should provide, among other things, that the maximum amount of the death proceeds available to the employer will be the total amount of premiums actually paid by him. It may well be that the cash surrender value will be greater than the total amount of the premiums paid by the employer. This could occur where dividends are used to reduce premiums and are added to the reserve of the policy or where there has been a waiver of premiums because of disability. In these instances payment of the full surrender value would result in a windfall to the employer. The agreement will also provide that the employee may buy out the employer's interest for the cash surrender value if the employee leaves or retires.

Bank Loan and Minimum Deposit Plans

Finally, brief mention will be made of bank loan and minimum deposit plans for the purchase of life insurance, which enjoy a certain popularity particularly among high-bracket taxpayers.

In essence, such plans involve the borrowing from a bank, or from the insurance company which issues the policy, the increment in the cash surrender value of the policy each year in order to pay the premiums then due. An income tax advantage arises by reason of the tax-free accumulation of interest on the savings or investment element of the policy (or in other words, the reserve or cash value), while at the same time the borrower gets, or hopes to get, a deduction for the interest paid on the loan.

A recent decision by the Supreme Court of the United States, in a case involving the purchase of single premium annuity policies with borrowed funds, held that the interest deduction claimed by the taxpayer should be disallowed because the transaction lacked "economic substance."[40] Whether this decision applies to purchase of

[40] Knetsch v. United States, 364 U.S. 361 (1960).

insurance with borrowed funds has been the subject of recent comment and speculation.[41] In any event, before a purchase of life insurance is made under the bank loan or minimum deposit plan, the client would be well-advised to have some sound economic reasons in addition to tax saving motives, if it is hoped to preserve the interest deduction.

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41 See 14 Journal of Taxation 160 (March, 1960); and 18, N.Y.U. Inst. on Fed. Tax. 479, 492 (1960).